Is a *Dollar Crisis* Coming?

Problems are lurking everywhere.

BY WILLIAM R. WHITE

The international monetary system remains dollar-based despite decades of warnings that the central role of the dollar was coming to an end. Some critics pointed to fundamental flaws in what economist José Antonio Ocampo has called a (non) system. It provides no automatic adjustment for persistent current account imbalances. It allows for significant, often damaging, policy spillovers from large countries (especially the United States) to smaller ones. There is no nominal anchor for global inflation, and, finally, there is no assured lender of last resort. Implicitly, these critics assumed that a system with such flaws could not long endure. Until now, they have been proven dead wrong.

Other critics pointed to developments that might have been expected, gradually but continuously, to lower confidence in the U.S. dollar as a store of value and as a medium of exchange. As the U.S. share of global GDP has continued to shrink, its capacity to service an ever-growing stock of international debt (the Triffin dilemma) has become increasingly questionable; surely "vendor financing" cannot continue forever? Moreover, concerns have been raised at various times about relatively high inflation in the United States as well as the relative commitment of the U.S. Federal Reserve to resist inflation. Massive increases in the U.S. government deficit and debt have recently raised fears that an excessively bipartisan Congress would lose control. This has led in turn to growing worries about "fiscal dominance"

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and eventually much higher inflation. Finally, resentment over the repeated use of the U.S. dollar as a geopolitical "weapon" was rising well before the imposition of sanctions on Russia.

Reflecting such arguments, many commentators predicted in 2006–2007 that the U.S. current account deficit would trigger a dollar crisis and then a global financial crisis. While a crisis did arrive, triggered ironically by events in the United States itself, the dollar did not fall but rose. We saw the same phenomenon at the beginning of the Covid pandemic. These developments reflected the dollar's underlying strengths—the size and liquidity of dollar markets, and trust in U.S. institutions and the rule of law.

Perhaps equally important, alternative currencies are not attractive enough. Sovereign debt markets have remained too small in Europe, and too constrained by capital and other controls in China, to ensure needed liquidity. And if the United States has political and macroeconomic problems, China and the eurozone have problems that are comparable or even worse.

Moreover, the United States does not want the dollar-based system to collapse and has supported it, both domestically with ever-expanding safety nets, and internationally through dollar swap arrangements. Similarly, other countries have resisted significant depreciation of the U.S. dollar, either by easing monetary policy to match easing by the Fed (mostly advanced economies), or through foreign exchange intervention (mostly emerging economies). While they have justified their actions as providing resistance to "excessive volatility," fears of losing competitiveness have also played a significant role.

However, to say the dollar has remained dominant in the international financial system is not to say that it must remain dominant. The international financial system is a "complex, adaptive system," like many other systems in nature and society, and has typical characteristics which have been well studied. Such systems can remain stable for long periods, even as imbalances build up under the surface, and can then suddenly implode when some event triggers a highly non-linear response. Recall the unexpected end of "The Great Moderation," the sudden demise of the Soviet Union, and many other unanticipated but significant events? Another global economic and financial crisis might yet provide a trigger for a dollar crisis as well. Unfortunately, there is a reasonable chance of another global crisis happening.

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Monetary systems driven by private credit expansion are inherently unstable. Today, prospective global problems are linked to the fact that U.S. monetary policy has been highly stimulative for decades. This should have led to a significant weakening of the U.S. dollar, but other countries resisted the associated strengthening of their currencies and, in effect, replicated U.S. policy at the global level. There are now many global indicators of growing economic and financial instability arising from these policies: record-high debt levels of decreasing quality, historically high asset prices, badly functioning and illiquid financial markets, and slowing growth rates for both investment and economic potential. In consequence, the negative economic effects of the recent pandemic and the invasion of Ukraine could yet prove as devastating as the effects of Covid on an individual with previous co-morbidities.

Current inflationary problems are not "transitory" but seem more likely to be sustained by a long list of overlapping and negative supply side shocks: pre-pandemic resource misallocations of capital driven by easy money, post-pandemic "hysteresis" affecting both capital and labor, population aging, climate change and the heavy costs of both adaptation and mitigation, commodity price increases, and finally deglobalization. Persistently high inflation could eventually lead to higher real interest rates that would reveal all of the underlying fragilities that have built up over the years.

Nor are we well-placed to manage another global crisis. Political problems are lurking under the surface

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almost everywhere, not least because of rising inequality, and these will be aggravated by either rising inflation or rising unemployment which disproportionally affect the poor. Moreover, our crisis management tools are heavily constrained or otherwise inadequate. Finally, needed debt restructuring will be constrained by inadequate laws and administrative procedures. Indeed, at the international level, we even lack basic principles to guide sovereign debt restructuring.

Why might another deep economic and financial crisis spark a dollar crisis when previous crises have not done so? The first argument is that the many reasons for expecting a sharply weaker dollar are still valid. The Triffin dilemma grows more acute with time. The U.S. current account has been in deficit for decades and it has recently expanded sharply as a percentage of GDP. Similarly, the net U.S. international investment position has been worsening almost exponentially. It is also notable that cyclical lows in the effective value of the dollar (1971, 1985, and 2001) have been successively lower and that the current effective level of the dollar is at a record high relative to that trend.

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A second argument is that important governments might lose their appetite for policies that support the current system. In a new crisis, instability in the U.S. market-based financial system could easily lead to a sharper economic downturn than elsewhere. Moreover, history indicates that the U.S. government and the Fed would attempt more radical forms of macroeconomic easing than others, letting the dollar adjust as needs be.

Should the availability of Fed swap lines also be constrained in the face of political pressure not to "bail out foreigners," this might temporarily strengthen the dollar but would also remove a longer-run prop supporting the system as a whole. Similarly, other important governments might wish to seize opportunities to claim parts of the "exorbitant privilege" provided by a reserve currency. In the eurozone, the recent expansion of bonds denominated in euros and issued centrally should provide a welcome expansion of liquidity in that market, even as liquidity in the market for U.S. Treasuries has deteriorated significantly. Nor is it implausible that this eurobond market will expand still further as new ways are sought to avoid "splintering" in the eurozone itself.

In China, authorities have long expressed their displeasure with the current dollar-based system. They could choose to let the renminbi rise strongly against the dollar, judging that the advantages provided (enhanced reserve status, geopolitical advantage, and support for stronger domestic consumption) outweighed the disadvantages (weaker trade account and capital losses on dollar assets). Might the recent decision of Chinese authorities to rebalance away from U.S. Treasuries and into other dollar assets presage a move away from dollars entirely?

A third argument has to do with new developments threatening the role of the U.S. dollar as a store of value and a medium of exchange. As to the former, the sanctions recently imposed by the G10 on the Bank of Russia, which cut off access to its foreign exchange reserves, raised widespread alarm among reserve managers in emerging markets particularly. As to the latter, the sanctions-related decision to bar a number of Russian banks from access to the SWIFT cross-border payments system could increase the attractiveness of alternative payment platforms like China's Cross-Border Interbank Payment System. That attractiveness might be further enhanced should new governance structures be proposed that would effectively make it impossible for the new system to be weaponized as SWIFT has been. Providing direct settlement in other non-G10 currencies, supported by the growing availability of hedging and trade credit facilities in such currencies, would provide further incentives to switch.

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Finally, the decision by Saudi Arabia and the UAE in 1973 to price all their oil sales in U.S. dollars buoyed the dollar after the shock of the closure of the gold window. In a significantly altered geopolitical and economic landscape, producers of commodities might now be increasingly prepared to accept payment in renminbi or other currencies.

What comes next in the event of a new crisis? Perhaps least likely is a new Bretton Woods system, internationally agreed, that would resolve all of the problems extant in the current non-system. Given all of our current and prospective political difficulties, the degree of international cooperation required for such an outcome would seem impossible to achieve.

Another polar outcome might be autarchy, as individual countries reacted to another crisis with trade protectionism, regulatory controls that effectively halt the international flow of capital, and competitive devaluations. Saying this could not happen, because it would have such enormous economic and political costs, amounts to a willful disregard of the realities of the 1930s.

More likely is that the dollar-based system will gradually evolve into a system based on currency blocks (the dollar, the euro, the renmimbi?) with exchange rates largely inflexible within the block but more flexible between. However, this presumes that, given a serious global crisis, both China and the eurozone would manage well the serious internal problems they already face: a massive debt overhang and the possibility of currency disintegration respectively.

This need for conditionality in speaking about the future reflects an underlying truth. It is essentially impossible to forecast the evolution of complex adaptive systems, though we feel compelled to try. ◆